FINANCING APPROACHES FOR STRATEGIC CAPITAL BUDGETING

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- Financing Options
- Cost Overruns
- Considerations When Applying Financing Approaches to Strategic Capital Budgeting

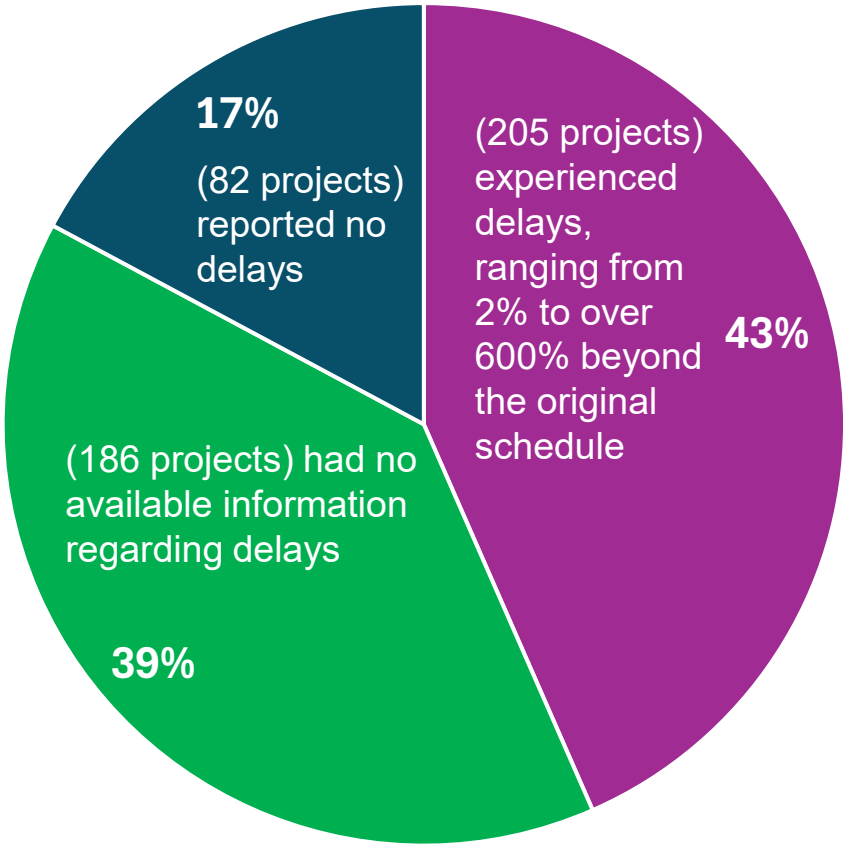
EFFICIENT FINANCIAL APPROACHES FOR CAPITAL BUDGETING

STRATEGIC CAPITAL BUDGETING

Financial sustainability:	• *Consider the long-term financial implications of capital projects, including sources of financing, operating costs, and potential impacts on public debt and revenues*
Long-term financial well-being:	• *Ensure that financial commitments under investment projects are met while providing essential services in the long term*
Process alignment:	• *Align capital investment planning processes - including portfolio scaling and analysis - and financing process, including the allocation and management of funds from various sources*
Accessibility and efficient use of funds:	• *Monitoring and reporting throughout the entire project implementation period*

CONSTRUCTION SECTOR TRANSPARENCY INITIATIVE: RESULTS

Out of the 480 projects analyzed:



- *Analysis focused on 480 public infrastructure projects across multiple countries and sectors:*
  - *Latin America (46%), Africa (35%), Afghanistan, Thailand and Ukraine (19%).*
  - *The road sector dominated the dataset (37%), followed by water, sanitation and education projects, totaling US$12 billion in public investment.*

Sources: CoST – Infrastructure Transparency Initiative – in partnership with the World Bank, the Government of Japan and the Quality Infrastructure Investment Trust Fund. 2024.

LONG-TERM FINANCIAL PLANNING IS THE KEY TO STRATEGIC PLANNING

A government should project its future revenues from different sources including tax and non-tax revenues (such as road user fees and charges, earmarked taxes, and other public service fees), potential external grants, and long-term debt to identify the aggregated level of public resources.

This aggregated level of public resources needs to be separated from annual operational spending so that public investment is not competing with public consumption in the resource allocation and decision-making processes.

KEY ACTIVITIES IN EFFECTIVE LONG-TERM CAPITAL PLANNING

Capital Inventory Development

Identification of long-term capital needs and projections for programs with predictable demand, regardless of financing availability

Comprehensive assessment of capital project cost and funding opportunities for programs and of individual projects, considering external resources such as grants and aids

Analysis of alternative methods for financing capital programs and projects

FISCAL SUSTAINABILITY IN LONG-TERM CAPITAL PLANNING

1. Forecast multi-year revenue and expenses to calculate net cash flow, and compare it to future capital investment needs outlined in a Capital Investment Plan (CIP).
2. Perform debt affordability analysis before issuing bonds to ensure debt stays within tax and revenue capacity.
3. Maintain an operating reserve to cover unexpected shortfalls, sized based on revenues, expenses, and economic conditions.
4. Set clear guidelines on which public projects are funded by current revenue and which by aq long-term debt.

HIGH-LEVEL CONSIDERATIONS FOR RESOURCE ALLOCATION

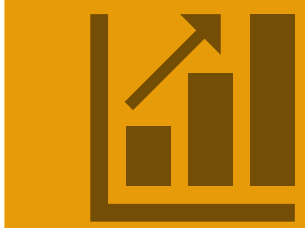
1. What are the benefits compared to the costs of the projects?

- In the short term, the focus is on static efficiency—allocating resources based on current sector capacity. In the long term, dynamic efficiency matters more, emphasizing sector improvement and the role of investment projects.

2. What are the possible ways to improve the economic efficiency of providing certain public goods and services?

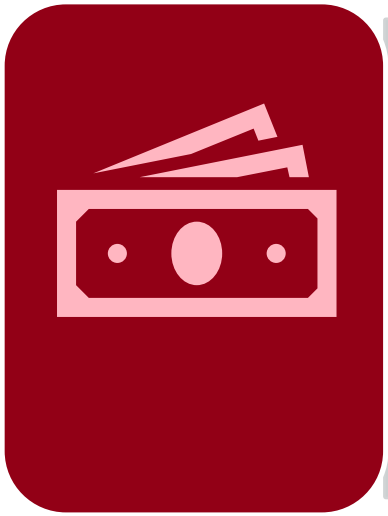
- In the short term, cost-efficiency efforts focus on minimizing costs without changing production methods. Long-term efforts allow for modernization and restructuring of government operations, often requiring investment.

HIGH-LEVEL CONSIDERATIONS FOR RESOURCE ALLOCATION *(CONTINUATION)*



3. Does a clearly defined debt policy exist and is it consistently followed?

- Policies on total debt and debt service prevent past spending from limiting current and future budgets.
  Debt affordability criteria help assess the ability to take on new debt.



4. Have any potential alternative financing options been considered and implemented?

- Non-traditional capital financing, often involving more private sector participation, is usually more complex and less transparent.
  The costs and benefits of alternative financing options should be clearly analyzed.

FINANCING OPTIONS

ADVANTAGES AND DISADVANTAGES OF CAPITAL FINANCING METHODS

Funding Mechanism and Assets/Projects	Advantages	Disadvantages
Pay As You Go (PAYGO) **• Assets that are not expensive, have short useful lives, benefit is achieved early, requiring matching local funds** **• Projects that can be reasonably phased given annual expenditures**	• Saves interest and other issuance costs • Preserves financial flexibility• Protects borrowing capacity• Enhances credit quality	• Generally insufficient for meeting large capital needs • Discourages intergenerational equity • Creates uneven flow of issuing debt
long-term borrowing **• Assets with long useful lives** **• Projects that are expensive to acquire or that exceed the capacity of the PAYGO program**	• Permits acquisition of assets as needed • Promotes intergenerational equity • Smooths capital expenditures	• Adds financial and administrative costs of procuring capital assets

Source: Srithongrung, Arwiphawee; Yusuf, Juita-Elena (Wie); and Kritz, Kenneth A., "A Systematic Public Capital Management and Budgeting Process" (2019). School of Public Service Faculty Publications. 41.

ADVANTAGES AND DISADVANTAGES OF CAPITAL FINANCING METHODS *(CONTINUATION)*

Funding Mechanism and Assets/Projects	Advantages	Disadvantages
Certificates of Participation **• Projects that are expensive to acquire or that exceed the capacity of the PAYGO program** **• Purchases of equipment, buildings, real property**	• Permits acquisition of assets as needed • Voter approval not needed	• Higher interest costs relative to issuing debt
Grants **• Assets qualifying for grant assistance (e.g., transportation projects)**	• Expands size of capital program with little or no cost to local taxpayers	• Limited amounts • Availability may not coincide with priorities • Administrative or compliance costs
Impact Fees/ Exactions **• Projects benefitting new developments (e.g., water, sewer, and transportation facilities)**	• Initial capital outlay can be funded at no cost to taxpayers	• Does not address ongoing maintenance or replacement costs • May be politically unpopular

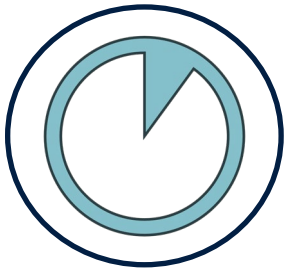
ADVANTAGES AND DISADVANTAGES OF CAPITAL FINANCING METHODS *(CONTINUATION)*

Funding Mechanism and Assets/Projects	Advantages	Disadvantages
Revolving Loan Programs **• Assets qualifying for loan assistance (e.g., wastewater treatment projects)**	• May lower financing costs	• Availability may not coincide with priorities • Administrative or reporting costs
State Bond Banks **• Projects of small governments appropriate for debt financing**	• May lower financing costs	• May not be available when needed • May impose burdensome requirements
Public/Private Partnerships **• Projects appropriate for franchising agreements, service contracts, or joint development**	• Lowers capital and/or operating costs	• Additional staff resources to negotiate, coordinate, monitor
Private Contributions **• Facilities adjacent to private properties**	• Lowers capital and/or operating costs	• Additional staff resources to identify contributors and coordinate activities

COST OVERRUNS

CONTINGENCY AMOUNTS IN A PROJECT BUDGET

Contingency funds help because delays raise costs, and extra time and resources are needed to approve additional funding.

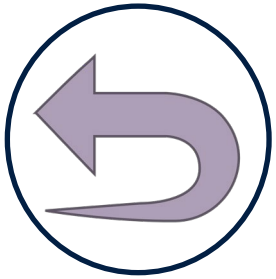


Contingency in project budgets is usually 2-10% of total costs, often around 5%. Complex projects like renovations may have higher contingencies.

Contingency amounts in a project budget boost spending flexibility, efficiency, cut management costs, and help finish on time.

UNSPENT FUNDS OF INCOMPLETE CAPITAL PROJECTS

Unused funds of incomplete projects may be carried forward to the next fiscal year until the project is completed or for a specified number of years.



Once project funds are unencumbered, redirection them to finance other projects.

CONSIDERATIONS WHEN APPLYING FINANCING APPROACHES TO STRATEGIC CAPITAL BUDGETING

QUESTIONS TO CONSIDER

1. Cost Estimation and Budgeting

- Is the total projected cost accurate, accounting for contingencies and inflation?
- Are the costs broken down into phases (design, construction, operation, maintenance)?
- Are lifecycle costs accounted for?

2. Funding and Financing

- What funding sources are being proposed (e.g., taxes, bonds, grants, PPPs)?
- Are the funding sources sustainable and legally permissible?
- Will this investment increase public debt? Is it within legal debt limits?

QUESTIONS TO CONSIDER *(CONTINUATION)*

3. Risk Assessment and Management

- What are the key financial, operational, and political risks?
- Is there a plan to monitor and mitigate these risks?
- What happens if cost overruns or delays occur?

4. Procurement and Delivery

- Does the procurement strategy incorporate a project and market needs analysis, supplier selection approaches, risk management measures, and key performance indicators?
- What procurement model will be used (e.g., design-bid-build,[1] design-build,[2] PPP)?
- Are the proposed procurement methods both transparent and competitive?

[1] This is a traditional approach where the owner first hires an architect or designer to create the design. Once the design is complete, contractors bid on the construction work based on the completed plans. The owner manages the design and construction phases independently. This method is often favored for projects prioritizing cost transparency and owner control.

[2] The owner contracts with a single entity for both design and construction, simplifying the management process. This approach can lead to faster project completion and potential cost savings due to early contractor involvement and streamlined communication. However, it can also increase complexity and uncertainty, with the design-builder bearing more responsibility for managing the project's scope, schedule, and budget.

QUESTIONS TO CONSIDER *(CONTINUATION)*

5. Long-Term Fiscal Sustainability of the Project

- What are the long-term maintenance and operating costs?
- Is there a financial plan for future capital renewal or replacement?
- How will the investment affect future budgets and services?

6. Long-Term Fiscal Sustainability of the Public Sector

- Are ongoing projects that are being successfully implemented receiving sufficient funding?
- Is adequate funding allocated for current expenditures within projects scheduled for completion during the forecast period?
- Is the projected fiscal space sufficient to maintain essential public services and fully meet debt commitments?

THANK YOU!